INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Statute involved	2
Statement	5
Argument	12
Conclusion	21

CITATIONS

Cases:

Adwood Corp. v. *Commissioner*, 200 F. 2d 552, certiorari denied, 346 U. S. 818 — 15

Central Kansas T. Co. v. *Commissioner*, 141 F. 2d 213 — 15

Dillon v. *Commissioner*, 213 F. 2d 218 — 19

Dunlap v. *Oldham Lumber Co.*, 178 F. 2d 781 — 20

Harriss v. *Commissioner*, 143 F. 2d 279 — 20

Helvering v. *Southwest Corp.*, 315 U. S. 194 — 13, 14, 15

Helvering v. *Taylor*, 128 F. 2d 885 — 16

McAllister v. *United States*, 348 U. S. 19 — 19

Rollingwood Corp. v. *Commissioner*, 190 F. 2d 263 — 18

Roosevelt Hotel Co. v. *Commissioner*, 13 T. C. 399 — 16

United States v. *Gypsum Co.*, 333 U. S. 364 — 19

United States v. *Hendler*, 303 U. S. 564 — 13, 15

Victory Housing No. 2 v. *Commissioner*, 205 F. 2d 371 — 19

Statute:

Internal Revenue Code of 1939:

Sec. 112 (26 U. S. C. 1952 ed., Sec. 112) — 2, 13, 15, 17

Sec. 113 (26 U. S. C. 1952 ed., Sec. 113) — 3

Sec. 117 (26 U. S. C. 1952 ed., Sec. 117) — 4, 20

Sec. 1141 (26 U. S. C. 1952 ed., Sec. 1141) — 17, 18

Internal Revenue Code of 1954, Sec. 368 — 16

Miscellaneous:

Federal Rules of Civil Procedure, Rule 52 — 18

336451—55——1

In the Supreme Court of the United States

OCTOBER TERM, 1954

No. 610

STOCKTON HARBOR INDUSTRIAL COMPANY,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 72–106) are not officially reported. The opinion of the Court of Appeals (R. 121–150; Pet. 55–95), from which one judge dissented in part (R. 150; Pet. 94–95), is reported at 216 F. 2d 638.

JURISDICTION

The judgment of the Court of Appeals was entered on November 1, 1954 (R. 151). Petition for rehearing was denied December 1, 1954 (R. 152). The petition for a writ of certiorari was

filed February 21, 1955. The jurisdiction of this Court is invoked under 28 U. S. C., Sec. 1254.

QUESTIONS PRESENTED

1. Whether the land taxpayer acquired from Lindley Patrick Farms, Inc., was acquired in connection with a "reorganization" so that, pursuant to Section 113 (a) (7) (B) of the Internal Revenue Code of 1939, taxpayer's basis for the land was the same as it would be in the hands of its transferor. The answer depends upon whether, as both courts below held, the exchange by which taxpayer acquired the land was an exchange of substantially all the assets of Lindley Patrick "solely" for stock within the meaning of Section 112 (g) (1) (C) of the Code.

2. Whether taxpayer's gains during the taxable years 1943 through 1945 from sales of the land are taxable as ordinary income rather than as capital gain under Section 117 (j) of the Code. The answer depends upon whether, as both courts below held, the land was held by taxpayer primarily for sale to customers in the ordinary course of its business.

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(g) [As amended by Sec. 213 (b) of the Revenue Act of 1939, c. 247, 53 Stat. 862] *Definition of Reorganization.*—As used in

this section * * * and in section 113 * * *—

(1) The term "reorganization" means * * * (C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation, but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded, * * *.

* * * * *

[26 U. S. C. 1952 ed., Sec. 112.]

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(7) *Transfers to corporation.*—If the property was acquired—

* * * * *

(B) in a taxable year beginning after December 31, 1935, by a corporation in connection with a reorganization,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. * * *

* * * * *

[26 U. S. C. 1952 ed., Sec. 113.]

SEC. 117. CAPITAL GAINS AND LOSSES.

* * * * *

(j) [As added by Sec. 151 (b) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(2) *General rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall

be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. * * *

* * * * *

[26 U. S. C. 1952 ed., Sec. 117.]

STATEMENT

The taxpayer, a California corporation, commenced proceedings in the Tax Court to determine the correctness of claimed deficiencies involving income taxes for 1943, 1944, and 1945, and excess profits taxes for 1944 and 1945 (R. 7–16, 18–28). Taxpayer's liability for these deficiencies depends on (1) whether it had acquired certain real property in a tax-free reorganization, and (2) whether it had held this property primarily for sale to customers in the ordinary course of business. The Tax Court held against taxpayer on both issues (R. 107–108). On appeal, the Court of Appeals for the Ninth Circuit affirmed (R. 151), by a 2–1 vote on the first issue, and unanimously on the second (R. 150).

The facts found by the Tax Court (R. 73–92) may be summarized as follows:[1]

[1] The evidence consists of stipulations of fact (R. 51–68), oral testimony (R. 30–35, 38–51) and exhibits. Pursuant to stipulation, the exhibits do not appear in the printed record (R. 118).

GENERAL FACTS

The taxpayer, a California corporation, was incorporated on October 16, 1936. Ten days later it acquired certain assets, chiefly land, of Lindley Patrick Farms, Inc. (hereinafter called Lindley Patrick), a California corporation, of which Albert Lindley was president, director and sole stockholder. The land was on and adjoining Rough and Ready Island, which is situated in the delta of the San Joaquin River near Stockton, California. The Stockton Deep Water Channel runs along the island's northern boundary to the Port of Stockton. (R. 73.)

The land had been acquired originally by Albert Lindley and transferred by him in 1926 to Lindley Patrick, a newly organized corporation, in exchange for all of its capital stock. In 1930 improvements for navigation were planned and made and a demand arose for parcels of the property for waterfront and industrial uses. (R. 73–74.)

FACTS BEARING ON THE REORGANIZATION ISSUE

Lindley Patrick had undertaken to sell its land in parcels for waterfront and industrial uses and by October 1, 1936, had sold approximately 200 acres but was in financial difficulties because of inability to pay $25,655.77 back taxes and mortgage interest. Debts of Lindley Patrick, secured by deeds of trust, totalled $128,153.62. The interest on such debts had not been paid for several

years and on October 1, 1936, totalled about $20,500. In addition, the land was subject to liens for delinquent county taxes in the amount of $3,767.36. (R. 74.)

On October 6, 1936, Lindley Patrick gave one Stuart L. Rawlings a written option "to purchase" its assets. Under the terms of the agreement a new corporation was to be formed to which the assets of Lindley Patrick, subject to the payment of Lindley's secured indebtedness and accured interest thereon, were to be transferred in exchange for 49 percent of the new corporation's stock; Rawlings was to receive 51 percent of the new corporation's stock for $30,000 which was to be used by the new corporation to pay Lindley Patrick's delinquent taxes and overdue interest, with any balance to remain in the treasury of the new corporation; and Rawlings was to lend $20,000 to Lindley Patrick to be secured by the pledge of its 49 percent of the stock of the new corporation. (R. 74–75.)

Later in October 1936, and as a result of the option agreement, the assets of Lindley Patrick (including 902 acres of the land with a then fair market value of $380,000, subject to the principal amount of the encumbrances) were transferred to taxpayer, the newly organized corporation, in exchange for what, in the resolutions of the two corporations and in taxpayer's application for a permit to issue stock, was stated to be a consideration consisting of 599 shares of taxpayer's capi-

tal stock and cash in the amount of $25,655.77[2] (R. 76–78). The $25,655.77 in cash, however, was the exact amount Lindley Patrick owed in back taxes and mortgage interest (R. 74).

The State Corporation Commissioner granted taxpayer permission to issue 599 shares of its stock to Lindley Patrick for "the property and assets described in its application * * * subject to liabilities and encumbrances not exceeding in the aggregate $153,809.39" (the total of Lindley Patrick's secured indebetedness, $128,153.62, and of its back taxes and overdue interest, $25,-655.77). This exchange was accomplished through a letter of instructions from Lindley Patrick to an escrow agent to whom Lindley Patrick delivered a deed to its properties and a demand note payable to Rawlings in the amount of $20,000 and taxpayer delivered the stock and the $25,-655.77. The letter of instructions directed the escrow agent to receive the stock from taxpayer and pledge it as security for the $20,000 note payable to Rawlings and to receive the $25,655.77 from taxpayer and apply it to the payment of Lindley Patrick's back taxes and mortgage interest, with any surplus to be returned to taxpayer. Endorsed on the instructions was a statement by taxpayer enclosing the stock and the $25,655.77 with directions that the $25,655.77 be

[2] A total of 601 other shares were sold for cash to members of the Rawlings group which organized taxpayer (R. 76–77, 79).

used in accordance with the foregoing instructions. Lindley Patrick was left with a small amount of assets and liabilities and did not dissolve. (R. 79–82.)

The Tax Court held that the transfer of Lindley Patrick's assets to taxpayer was solely for stock within the meaning of Sections 112 (b) (4) and 112 (g) (1) (C) of the 1939 Internal Revenue Code and thus constituted a tax-free reorganization, so that under Section 113 (a) (7) of the Code taxpayer's basis for the land was the same as that of its transferor (R. 92–98). That holding was based on conclusions that (1) the $25,655.77 payment by taxpayer represented payment on liabilities of Lindley Patrick which taxpayer assumed (the liabilities for back taxes and overdue interest) and therefore is to be disregarded under Section 112 (g) (1) (C); and (2) that the $20,000 personal loan by Rawlings to Lindley Patrick did not constitute consideration moving from taxpayer to Lindley Patrick. The Court of Appeals affirmed, with one judge dissenting on this issue (R. 129–138, 150; Pet. 66–79, 94–95).

FACTS BEARING ON PURPOSE FOR WHICH LAND WAS HELD

Taxpayer acquired the land from Lindley Patrick for the purpose of developing and selling it as industrial property (R. 83), the land being unusually well suited to industrial, dockage and warehouse sites (R. 87). Taxpayer's powers and purposes, as stated upon its incorporation, were,

among other things, "to acquire, own, subdivide, develop, improve, buy, sell, lease * * * all kinds of land and personal property; * * * to transact any other kind of business that may be beneficial and desirable for the stockholders" (R. 76). Taxpayer's application to the Corporation Commission to issue stock included the statement "that this corporation has been formed and organized primarily for the purpose of acquiring and dealing in real estate of all kinds, and of improving, subdividing, and selling the same" (R. 77–78). The application also explained in detail that taxpayer's officers were experienced in the real estate business (R. 78–79). Upon its organization, taxpayer received much publicity from the local newspapers with respect to the development of its properties for industrial uses (R. 84–85).

While taxpayer held the land it continued its efforts to sell but in the meantime leased the land to farmers for agricultural purposes, including grazing (R. 83–84). In 1937, taxpayer executed an oil and gas lease covering this property, but neither oil nor gas was discovered (R. 83). Taxpayer did not subdivide the land into sites or tracts but preferred to treat it all for sale and to locate individual industries, from point to point, in accordance with their respective requirements and without permitting any haphazard or destructive selections (R. 88). Taxpayer's letterhead on its stationery gave its business as "Wharf, Warehouse and Manufacturing

Sites" and the back of the stationery contained a map of these sites (R. 86–87). In 1939 taxpayer engaged an attorney as its agent to effectuate the sale of part of its property for the purpose of locating a shipyard thereon to be operated by the Kaiser interests. The agent's efforts were unsuccessful but from time to time taxpayer granted the agent assignable options to purchase a part of the property and entered into written agreements with him as to the compensation he was to receive for his efforts. (R. 85–86.)

In March 1942, Albert Lindley, then a director, vice-president and general manager of taxpayer, exhibited the property to two real estate brokers for the purpose of acquainting them with the property and informing them of the prices at which the various parcels were available for sale, the understanding being that the brokers would receive the usual real estate agent's commission if they were instrumental in bringing about the sale of any of the properties. Lindley informed the brokers that taxpayer was primarily interested in selling rather than leasing parcels of the property but that prospects for leases would be given consideration. (R. 88–89.) In September 1942, taxpayer wrote to the internal revenue agent in charge, in a letter protesting a proposed income tax deficiency for 1939 and 1940, that "[t]he real properties of the corporation are held primarily for sale" (R. 87–88).

Despite its efforts to sell the land, taxpayer's actual sales were relatively infrequent. In 1937 it made two sales, one of 13.028 acres to General Petroleum Company for $15,000 and one of 1.69 acres to the State of California. In 1940 it also made two sales, one of 13.03 acres to Shell Petroleum Company for $25,000 and one of 1.78 acres to the State of California. In 1943 taxpayer sold an islet comprising 4.77 acres for $2,500 and in 1944 sold 213.83 acres for $42,000, less selling expenses. In 1944 the United States, with the encouragement of taxpayer, instituted condemnation proceedings and took over taxpayer's land on the island for an agreed price of $415,000. In 1945 taxpayer sold the remainder of its property to Albert Lindley for $15,000 and dissolved. (R. 89–91.)

The Tax Court found as a fact and held that taxpayer acquired and held its real property until final disposition in 1945 primarily for sale to customers in the ordinary course of its business, with the result that taxpayer's gains from the sale of the land in the years 1943 through 1945 are taxable as ordinary income rather than as capital gain under Section 117 (j) of the Code (R. 92, 99–106). On this issue, the Court of Appeals unanimously affirmed (R. 138–150; Pet. 79–94).

ARGUMENT

The decision below is correct and no conflict or question of importance is presented. Further-

more, the second issue (*supra*, p. 2), involving the purpose for which taxpayer held the land, is basically one of fact, on which the Tax Court's findings (R. 83–92, 99–106) have been unanimously upheld by the Court of Appeals (R. 138–150; Pet. 79–94).[3]

1. *The Reorganization Issue.* Contrary to taxpayer's argument (Pet. 9–12), the decision below on this question (*supra*, p. 2) is not in conflict with this Court's decision in *Helvering* v. *Southwest Corp.*, 315 U. S. 194. That case did, of course, involve the question whether the assets of one corporation were transferred to a newly organized corporation "solely" for stock within the meaning of Section 112 (g) (1) (C) and in that connection a question was raised as to the effect of the *Hendler* amendment.[4] But in the *Southwest Corp.* case, the taxpayers sought to apply the *Hendler* amendment to a creditors' plan of reorganization under which the non-par-

[3] Judge Chambers' partial dissent in the Court of Appeals was limited to the tax-free reorganization question (R. 150; Pet. 94).

[4] The so-called *Hendler* amendment retroactively provided that "in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded * * *." This language was added to Section 112 (g) (1) (C) of the 1939 Code by Section 213 (b) of the Revenue Act of 1939, c. 247, 53 Stat. 862, and by Section 213 (g) of that Act was given retroactive effect to 1934. As this Court recognized in *Helvering* v. *Southwest Corp.*, 315 U. S. 194, 199, that amendment was made to avoid the consequences of *United States* v. *Hendler*, 303 U. S. 564.

ticipating security holders were paid off in cash obtained by a loan from a bank which the newly organized corporation assumed and later paid. The Court held the *Hendler* amendment to be inapplicable because, although the assumed liability had its origin in obligations of the old corporation, it was a substitute liability which was fixed in the reorganization proceeding itself, as distinguished from a pre-existing liability of the old corporation. Thus, in the *Southwest Corp.* case the Court drew a distinction, in connection with the application of the *Hendler* amendment, as to the nature of the assumed indebtedness, and not, as taxpayer assumes (Pet. 12, 14), as between an assumption of indebtedness and an assumption of indebtedness accompanied by immediate payment.

In this connection, this Court stated, 315 U. S. at 199–200:

> [The *Hendler*] case dealt with a situation where an indebtedness which antedated the transaction in question was assumed by the transferee. There the debt assumed clearly was a "liability of the other" corporation. The situation here is quite different. The rights of the security holders against the old corporation were drastically altered by the sale made pursuant to the plan. * * * Though the liability assumed had its origin in obligations of the transferor, its nature and amount were determined and fixed in the reorganization.

> It therefore cannot be labelled as an obligation of the "other" or predecessor corporation within the meaning of the 1939 amendment.

The Court of Appeals specifically discussed and adopted this distinction drawn in the *Southwest Corp.* case (R. 131–133; Pet. 69–72). Thus, rather than creating any conflict, as claimed by taxpayer, the decision below adopts a distinction which is wholly consistent with the rationale of that case.

The *Hendler* case itself, as the Court indicated in its opinion in that case, 303 U. S. 564, 566, involved a transaction under which the transferee corporation assumed and *immediately paid* a pre-existing liability of the transferor corporation as part of the plan of reorganization. Since Congress intended to avoid the consequences of the *Hendler* decision, it obviously intended to effect a result opposite to that reached in the *Hendler* case. Where, as here and as in *Hendler,* the transferee corporation assumed and paid a pre-existing liability of the transferor corporation, the case is squarely governed by the *Hendler* amendment, contained in Section 112 (g) (1) (C) of the Code.

The decision below is not in conflict with *Central Kansas T. Co.* v. *Commissioner,* 141 F. 2d 213 (C. A. 10th), or *Adwood Corp.* v. *Commissioner,* 200 F. 2d 552 (C. A. 6th), certiorari denied, 346 U. S. 818. The conflicts are asserted by taxpayer "[f]or the same reasons" as the as-

serted conflict with the *Southwest Corp.* decision (Pet. 18), and the two cases are distinguishable for the same reason as the *Southwest Corp.* case, as shown above and in the opinion of the Court of Appeals (R. 133–136; Pet. 72–76).

No important question is raised by the holding below with respect to the applicability of the *Hendler* amendment. Taxpayer's assertion that the decision opens a dangerous loophole (Pet. 18–21) is based on an unwarranted assumption that the decision below may be extended to support a holding that, contrary to decisions of this Court, a sale of corporate assets for cash constitutes a reorganization. Furthermore, taxpayer is incorrect in arguing (Pet. 16–17) that the decision below may dangerously affect the application of a new provision inserted in the 1954 Code. That provision, Section 368 (a) (2) (B), does not modify the *Hendler* amendment, which is retained in Section 368 (a) (1) (C) of the 1954 Code; the new subsection is an additional liberalizing provision. This case involves only the *Hendler* amendment, which the court below was required to apply. Its decision in that connection is clearly correct. See *Helvering* v. *Taylor,* 128 F. 2d 885 (C. A. 2d); *Roosevelt Hotel Co.* v. *Commissioner,* 13 T. C. 399.

No question of importance is raised by the holding below that the $20,000 loan made by Rawlings to Lindley Patrick did not preclude a con-

clusion that the transfer of Lindley Patrick's assets to taxpayer was solely for stock within the meaning of Section 112 (g) (1) (C) of the 1939 Code, *supra,* pp. 2–3. Taxpayer claims that holding also opens a dangerous loophole (Pet. 23–25), apparently as applied to the provisions of the 1954 Code. But, as the court below held (R. 130; Pet. 68), the $20,000 loan by Rawlings was not part of the consideration moving from taxpayer to Lindley Patrick and, since it therefore was not a part of the exchange between the two corporations, has no effect so far as the application of Section 112 (g) (1) (C) is concerned.

2. *Purpose For Which Land Was Held.* With respect to the holding below as to this issue, taxpayer makes various assertions relating both to the scope of review and to the correctness of the result reached. Such assertions cannot disguise the fact that taxpayer is simply seeking review by this Court of what is essentially a factual issue.

Taxpayer attempts to find in the decision below an application of the extinct *Dobson* doctrine as to the proper scope of appellate review (Pet. 25–28), and on this theory suggests the existence of a possible conflict with numerous other decisions which recognize that the scope of review is whether the Tax Court's decision on a factual question is "clearly erroneous," as provided by 26 U. S. C. 1952 ed., Sec. 1141 (a) and Rule

52 (a) of the Federal Rules of Civil Procedure. These contentions are refuted by the opinion below, which, at its very outset (R. 122; Pet. 56), quotes the pertinent language of Section 1141 (a) and expressly states that the scope of its review is to be governed by that section.[5]

Furthermore, immediately before considering the evidence relating to the fact findings on this issue, the Court of Appeals also stated (R. 140; Pet. 81) that in reviewing fact findings of the Tax Court it had to determine whether that court's conclusion "is warranted" in the "light of the facts before the court, and the inferences [the Tax Court] was free to draw from oral testimony and written documents." Thereupon, the appellate court considered at length the actual evidentiary basis for the Tax Court's determination that taxpayer had held its land primarily for sale to customers in the ordinary course of its business, and concluded that this holding was warranted (R. 140–150; Pet. 81–94).[6] The re-

[5] This section, as amended by Section 36 of the Act of June 25, 1948, c. 646, 62 Stat. 869, provides that Tax Court cases are to be reviewed "in the same manner and to the same extent as decisions of the district courts in civil cases tried without a jury."

[6] In a previous case involving the same question—whether property of the taxpayer was held primarily for sale to customers in the ordinary course of business—the court below specifically stated that the "clearly erroneous" rule was applicable. See *Rollingwood Corp.* v. *Commissioner*, 190 F. 2d 263, 265.

viewing court thus gave careful and adequate consideration not only to the detailed findings of the Tax Court, but, in addition, to the testimony of the witnesses, and has fully met the requirements of Section 1141 (a).

Contrary to taxpayer's assertions (Pet. 29–31), the scope of review under the "clearly erroneous" rule is not a question on which it is necessary to have further clarification by this Court. In *United States* v. *Gypsum Co.*, 333 U. S. 364, 395, the Court stated that a "finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." This rule was recently reaffirmed in *McAllister* v. *United States*, 348 U. S. 19, 20. The result reached by the court below is wholly consistent with that pronouncement.

Still further with respect to the scope of review, taxpayer asserts conflicts on the basis of the holding of the court below that the question presented—whether property is held primarily for sale to customers in the ordinary course of business—is a question of fact (Pet. 33). In the very two cases cited by taxpayer as in this respect conflicting with the decision below, *Dillon* v. *Commissioner*, 213 F. 2d 218 (C. A. 8th); *Victory Housing No. 2* v. *Commissioner*, 205 F. 2d 371 (C. A. 10th), the question was treated as one of fact to be considered under the 'clearly erroneous" rule. The Tax Court was reversed in those

cases but that was because the appellate court was of the view that there was no evidence to support the Tax Court's factual conclusion.[7]

Finally, taxpayer is incorrect in asserting (Pet. 35–46) that the question presented on the merits is important and that there is a conflict of decisions in that connection. The statutory language, requiring a determination of whether property is "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" (Section 117 (j), *supra*, pp. 4–5) is clear and requires the resolution of what is primarily a factual question to which no single conclusive criteria can be applied in all cases. The decisions here asserted to be in conflict with the decision below, *Harriss* v. *Commissioner*, 143 F. 2d 279 (C. A. 2d); *Dunlap* v. *Oldham Lumber Co.*, 178 F. 2d 781 (C. A. 5th), are simply cases in which, on different facts, it was held that the property involved was not held primarily for sale to customers in the ordinary course of business.

[7] Other asserted conflicts in this connection (Pet. 33–34) are further removed from the present case and just as strained.

CONCLUSION

No important question or conflict of decisions is involved. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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